RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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May 18 DJIA 1133.79; PTI 1623; A-D Ratio -21.54
May 25 DJIA 1107.10; PTI 1598; A-D Ratio -21.54

THE MARKET: The single most important fact the investor can possess is a knowledge of the direction of the primary trend. It is an axiom of the Dow theory that no man can know in advance the extent or duration of a primary movement, either bull or bear. And that, in a nutshell, is why it is crucial to be invested in harmony with the great tide of the market, which we call the primary trend.

We have had a number of bull and bear markets since I began writing this Letter back in 1958. During those 25 years we have had only one really disastrous bear market, and that was the bear market of 1973-74. That period provided many of today's newer investors with their first taste of monumental losses. Nevertheless, despite the severity of the 1973-74 experience, the fabric of the nation, its banks, its government, its financial institutions, that fabric held together.

There are many who believe that at this stage of the game (in view of the unbelievable amounts of debts outstanding), that the country could not weather another major bear market. I plead ignorance. I simply don't know. But I have to operate as if I will survive, the nation will survive, and my subscribers will survive. Correct procedure in investing has carried many a Dow Theorist through many terrible bear markets. I have faith that correct procedure will carry us through this one.

As I say, no man, no expert, no board of directors, no group of economists can predict what is coming in the period ahead. But I can tell you this: the Dow Theory has signalled almost from the beginning of this year that a bear market is on. If there was any doubt about this (and there has been a lot of doubt) the action of my Primary Trend Index (PTI) should have settled those doubts as far as my subscribers are concerned. The PTI topped out on January 17, it broke below its 21-week moving average on February 6, and it has been going down ever since. I have documented this with words and charts in every Letter since.

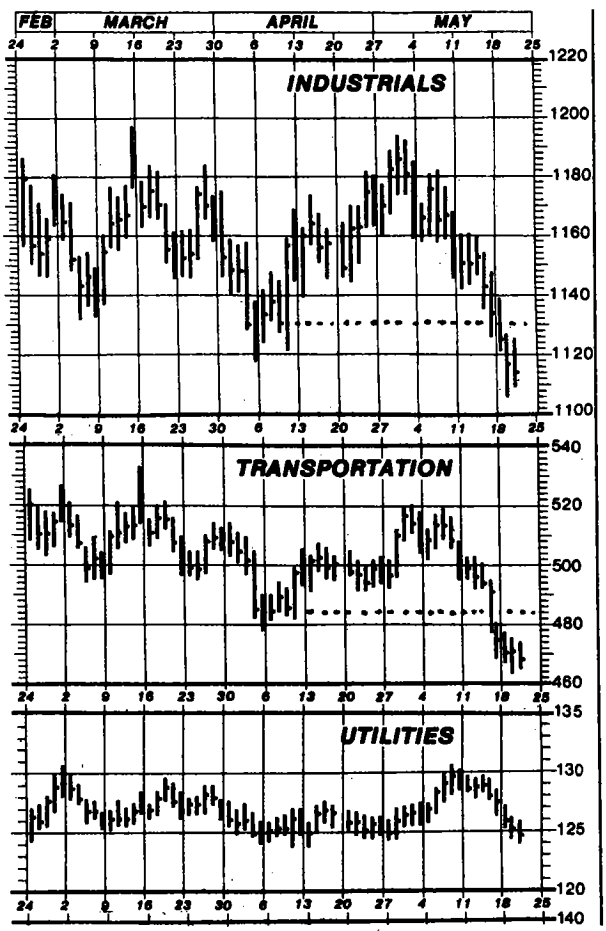
Last week (May 21) the bear tide was reconfirmed as the D-J Industrials finally broke below their April 5 low of 1130.55—thereby confirming the bearish Transport penetration that occurred a few days earlier.

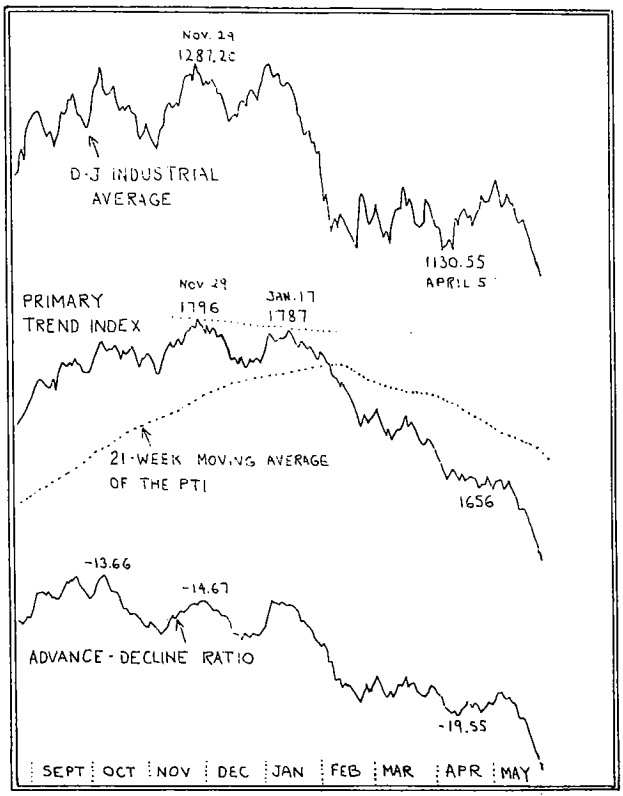
On May 22 two major holdouts to the downside also confirmed the bear trend. On that day the Standard & Poor's 500 Index broke to a new low below its 1984 low of 154.29. On the same day the NYSE Composite sank below its own 1984 low of 88.69. A day earlier the NYSE Financial Index (composed of hundreds of financially related stocks, banks, saving and loans, insurance companies, small loans) cracked to a new 1984 low. The bear market, by the middle of last week, was fully in gear on the downside.

One interesting facet has been overlooked by most observers. Primary movements tend to last LONGER than the counter-trend movements which correct them. This concept is very important in considering the action of the advance-decline ratio (which is a proxy for ALL the stocks in the NYSE). The A-D ratio recorded its bull market peak in mid-June, 1983. This peak occurred ten months after the 1982 August low. But the A-D ratio has been declining ever since June 1983, a period (so far) of over eleven months. Thus, the declining phase of the A-D ratio has *already outlasted the advancing phase!* The implication again is that the primary (longer) trend is down. The period since June 1983 has been a primary bear market for the majority of stocks on the NYSE, as measured by the A-D ratio. How long the A-D decline will last no one can say. The market is a law unto itself.

All manner of so-called experts are now advancing reasons "why" the market is going down. But the reasons given are, in general, the obvious ones, and the market is usually far ahead of the obvious. A few comments along these lines, however, may not be amiss.

(1) The stock market continues to face murderous competition from the bond market. For instance, on the latest reading





Barron's stock/bond yield spread was a record 7.83% in favor of bonds. To give you an example of what this means, at 7.8% money doubles in less than 10 years. That tells you that at the current bond yield advantage, the differentials (in other words, the "extra" return you receive from bonds) doubles in less than 10 years. Now that's tough competition.

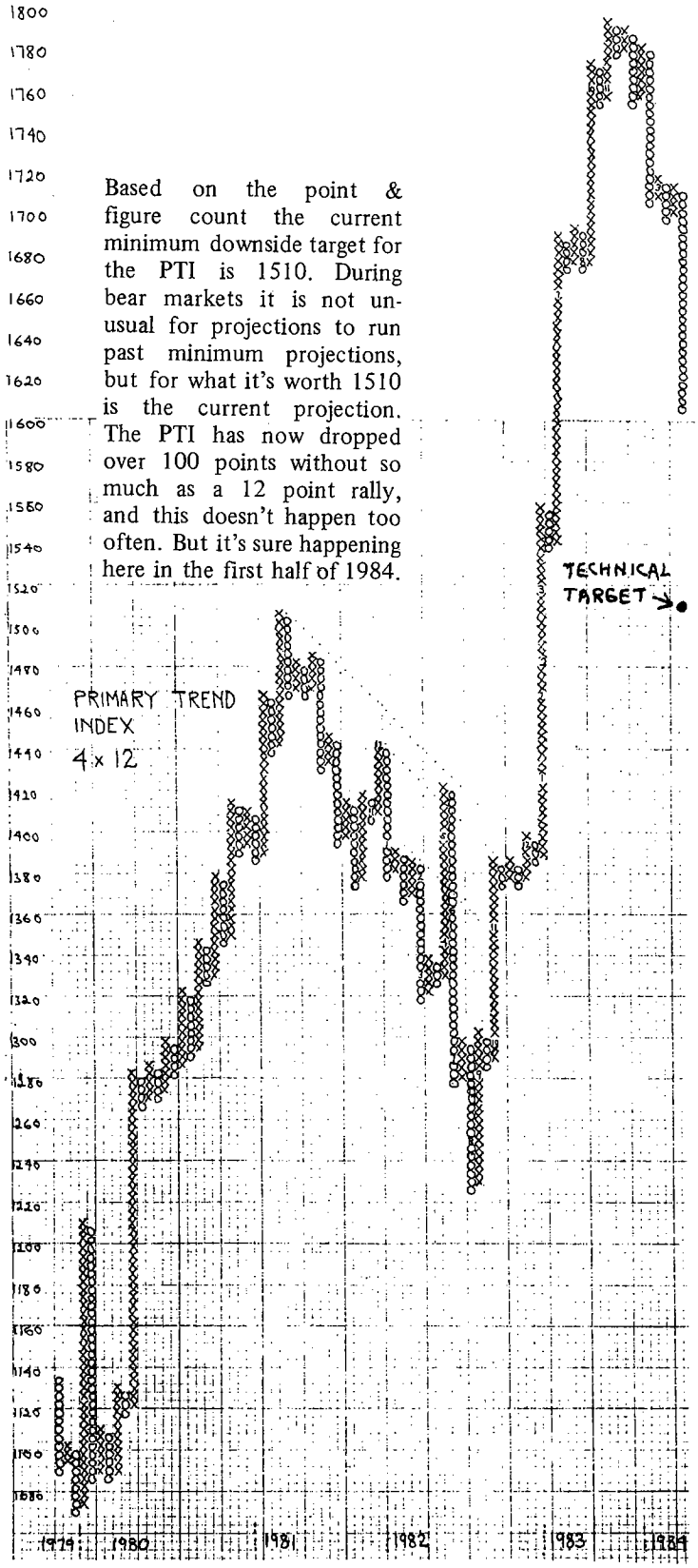
Listen to this statement from Merrill Lynch's top analyst, Bob Farrell (and bear in mind that this is a brokerage house-research comment!): " . . . the capitulation stage in bonds now is the opposite of the enthusiasm for aggressive growth stocks a year ago. Aggressive growth stocks peaked in an orgy of demand when valuations were on the roof. Now bonds are almost being shunned at any price despite a risk-free nominal return (13.5%) that 95% of stock managers are not likely to beat on a 10 year or longer basis."

I don't know whether Bob picked that up from me or not, but I have been saying that over the last 10 years the current total return on the S & P 500 is 11.1% as against a guaranteed return of over 13% on US Treasury bonds. If you will check the record, not too many money managers can do better than 13% over a 10 year period.

(2) A second major worry is the Continental Bank situation and all that it implies. Fearful lest the Continental (the Nation's 7th largest bank) go belly-up, other major banks plus the Fed put up $7.5 billion in credits to stem the flow of deposits out of the Continental. But nobody yet knows how bad the situation is or how much it reflects on the entire US banking system. One thing we do know is that the banking system is awash with so-called "non-performing" loans. Everyone knows that on a strict statistical basis, the banking system is already under water. But everybody hopes (like the emperor's clothes) that nobody notices. This is a "keep your fingers crossed" situation.

(3) Every economist and his brother sees good business during the rest of 1984–even though they allow for a slowdown. But

Based on the point & figure count the current minimum downside target for the PTI is 1510. During bear markets it is not unusual for projections to run past minimum projections, but for what it's worth 1510 is the current projection. The PTI has now dropped over 100 points without so much as a 12 point rally, and this doesn't happen too often. But it's sure happening here in the first half of 1984.



Richard Russell and his subscribers know that a primary bear market is on, and the bear thrives on making fools of the forecasters.

(4) The Mideast is heating up again, with Iran and Iraq acting (as they generally do) in a manner just this side of insanity. Thus, both nations are attacking Saudi oil tankers, and the US is issuing warnings. To be continued . . . .

(5) The Russians, according to the popular wisdom, are furious at Mr. Reagan, and the Olympic pull-out was simply a slap at

Reagan. But many of us are not so sure it is as simple as all that. I happen to think that the Russians are sending a message out to the world–about where the power is and whose side your bread should be buttered on. Listen to this from the front page of the May 21 New York Times:

> **To some of the experts, the statement today by Foreign Minister Andrei A. Gromyko at a luncheon in Moscow for the visiting West German Foreign Minister, ruling out a return to arms control talks, and the announcement Sunday by Defense Minister Dimitri F. Ustinov about additional Soviet submarines near United States coasts are part of a pattern that, in retrospect, began to emerge last fall.**
>
> **The pattern entails a flexing of Soviet missile and naval power, collisions at sea, minor harassment of airliners to and from West Berlin, firing at an American helicopter that strayed into Czechoslavak airspace, a virtually total cessation of direct arms control talks and a stream of tough negotiating stances that may not be easily set aside.**

(6) Most people don't comprehend this, and I've stated in previous bear markets–every night when the sun goes down every share of stock and every bond certificate is OWNED by somebody or some institution. During a primary bear market those values are diminishing, they are going down and down. Thus, the net value of the system is diminishing, and the net value of individuals, corporations and institutions is shrinking. This exerts a steady, adverse pressure on the finances and psychology of all who live through a bear market. In other words, the longer the bear lasts, the poorer we are and the poorer we feel.

Few, very few people escape the clutches of the bear. For one person it may be a loss of paper profits, for another it is a loss of assets, for another it is a loss of his business, and for still another it is the loss of a job. Just as we all are floated skyward by a bull market, we are all pushed toward the basement when we are in the clutches of the bear.

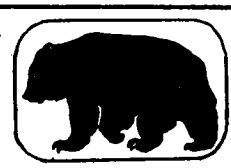
I've said this before, and I'll repeat it. Only a fool expects to "do well" during a bear market. A bear market is a period when we are tested for our survival abilities. *"The man who loses least is the winner" when a bear market is on.*

This bear market seems to have crept up on everybody, and by that I mean that it has been a lot more vicious than most people realize. Since its mid-1983 high, the A-D ratio has now lost 11 points, and this index is now down to its level of late-1983. Since its November 29, 1983 high of 1296, the PTI has lost 196 points. Since the beginning of 1984 the PTI has been down 17 of 21 weeks or 81% of the time!

Turning to the current action, the D-J Utility Average (the last hold-out) broke below its 123.70 low on May 24, thus giving total confirmation to the bear side. The market has been in free-fall over the past few weeks, and such action normally ends in only one way–exhaustion. Talk of "support areas" and "target zones" are nonsense in such situations.

Most investors fail to realize that the technical indexes, gauges and various methods usually tend to malfunction during a true primary bear market. Oversold conditions go to amazing extremes, indicators drop off the bottoms of the charts, normal areas of overextension are wiped out as the bear continues its rampage. That is what is happening as this Letter is written. The decline will halt when the sellers are exhausted–just as a speeding car stops when it runs out of gas.

INVESTMENT POSITION: I know that the majority of advisors have been talking about "cutting back" or holding "the strongest stocks" as the market goes down. They know people love action, love to buy, no matter what the market is doing. I don't operate that way. I follow the teachings of the great Dow Theorists such as Hamilton, Rhea, and Schaefer. None of them advocated riding out a bear market with stocks, and my own experience confirms this approach.



For this reason, I have told my subscribers to get on the sidelines, to get liquid, to stay in money market or T-bill instruments, and to abstain from guessing "when the bottom will arrive." What good is the bottom if we are demoralized or broke? What good is a bottom if we're too paralyzed to act on it? The bear is in this box, we've got reconfirmed bear market signals according to Dow Theory, and my PTI is probing new low ground. What more can I say?

QUESTIONS: Russell, do you think this is the great unraveling that you have warned about since 1980? What are these markets trying to tell us?

Answer: I wrote in 1980 that the forces of inflation (caused by monetizing the debt) had finally run head-on into the forces of deflation (brought on by the colossal costs of carrying the debt). At this point, few fundamentalists or economists really know what is happening. We see the debt markets collapsing, we see the stock market caving in, we see foreign markets (Britain, Japan) starting to buckle, we see housing prices in most areas (except New York) leveling off or actually declining, we see commodities level on balance, and we see the precious metals creaking lower.

Question: OK, so what do you make of all that?

Answer: Well, I know one thing I don't make of it–it is not inflationary. The strongest item of 1984 has been the dollar, which is another way of saying that the hottest thing around is liquidity. Meanwhile, many nations and many institutions are being held up (literally being kept alive) by loans, standby loans, massive infusions of credit, and promises of more credits by banks, the IMF and the Federal Reserve.

Question: Do you think that this is the big bear market that so many people have been thinking about? Is this the bitter end?

Answer: That's a question that no man alive can answer. Robert Rhea, the great Dow Theorist, repeatedly stated that "Neither the extent nor the duration of a primary movement can be predicted in advance." Under that line of reasoning, any bear market could be "the killer." And those of us who desire to survive must treat each primary bear market as if this is the one that is "out to break us." There is one phenomenon that applies to EVERY primary bear market. It is that every bear market produces many more losers than winners.

When the big bear market finally arrives, the one that will correct four decades of inflation, I expect the losses to be staggering.

I've said this before, but I think it bears repeating: "In a major bear market it's the person who loses LEAST who is the winner." Everyone loses in a major bear market, but if you can retain say 75% or more of your assets during a major bear market, that's a good performance.

In a recent Letter I showed where Bernard Baruch lost millions during the 1929-32 smash, but Baruch came out with maybe $8 million. That was $8 million more than anybody else had, and it was comparable to $100 million today. Thus, Baruch weathered the worst bear market in history and came out a rich man. So I'm sure Baruch blessed the millions he came out with rather than cursed the millions he lost.

Question: Russell, I note that you keep harping about interest rates and money market instruments as values. Why are you so obsessed with interest rates?

Answer: If you're a borrower, interest rates are the cost of doing business. If you're a lender, interest rates represent your return on investment. Most investors do not understand money, and therefore they don't understand the meaning of what they are doing. You invest to obtain income through dividends, interest and appreciation. You speculate to try to beat time (i.e., to try to obtain appreciation faster than via compound interest). But basically, both the investor and the speculator (although I am not sure they understand this) want to put their money TO WORK. As I say, the only difference is in the amount of risk they are willing to take and the amount of time they are willing to wait.

Seasoned investors know that there are three items which they must deal with and these are (1) safety of principle, (2) return, (3) possible appreciation. When you buy ten-year Government bonds, for instance, you have great safety of principle, you know exactly what your yield is, but you do not know about appreciation. In fact (as bond holders know) you can show a big paper loss in the bonds until they near maturity, at which time you will get your money back (although no one knows what money will be worth in ten years).

When you buy a T-bill you are getting safety, a good yield (but maybe 3.5% less than a T-bond) and you don't worry about fluctuation since you can get your money back quickly, in three months if you want.

Now consider this: if you look at a ten year maturity T-bond yielding 13.5% and also an equal amount of say General Electric yielding 3.7%, you must consider that the bond is providing a yield differential of almost 10% over the GE dividend. Thus, to come out ahead in ten years GE will have to boost its dividend an average of 10% a year to compete with the bond. If it can do that (which would be an incredible performance) then the stock would obviously appreciate and you might come out ahead (although you would have to pay capital gains on the appreciated stock when you sold it).

But then we come to safety. Which is safer, a guaranteed 13.5% return on a T-bond or a hoped for ten year appreciation with accompanying dividend boosts in GE? My own opinion is that the guaranteed return on the bond surpasses the hope of comparable or better return on GE. And that, in a nut shell, is the problem the stock market faces today.

But you and I as investors have to understand that the reason we are investing is to preserve or (hopefully) to improve our standard of living. No it's true, an awful lot of people enter the markets for the same reason that millions of people go to Atlantic City or Vegas–they like the excitement. I've tried for years to discourage my readers from using the markets as a source of excitement. The markets should not be a substitute for Vegas, they should be a place where you put your money to work in the hopes of providing something useful. That "something" is a return, which can be used to provide a decent standard of living (or even a luxurious standard of living if you're so inclined).

Thus, in the very beginning you must get your priorities straight, and you must adopt a sane philosophy regarding why you are working, why you are investing, and what you want out of life. Wise men use the markets literally as a second business, a second source of income. Fools use the markets to amuse themselves, and generally their results are costly and anything but amusing.

Question: Russell, to get back to interest rates, what do you think is coming up in the bond market?

Answer: The bond market, and particularly the Treasury market, is facing a difficult supply demand situation. Nobody seems to want long bonds. The thirty years bonds are near 14% yield, and this 14% is tending to drag down everything else. But even if the Government doesn't issue any more 30 year bonds, the existing bonds will tend to set prices. And the more fear, the lower those bonds go and the higher the longer term interest rates.

Eventually, there will come a time when large interest will say, "At these yields I simply can't resist." At 14% or 15% or 17% there will come a point where the big money will step in. At that point we will have a major floor and an important rally in the bond market. In 1982 that interest rate level was roughly 15.25 for the long T-bonds. No one knows where the "buy level" will be during 1984 or 1985.

My own inclination (at least as I sit here today) is that 15% T-bond interest becomes almost irresistible.. $100,000 in a pension plan at 15% becomes $400,000 in ten years. That's a mathematical certainty, not a hope. Thus, ten year bonds at around 15% become items that this writer couldn't resist. If I buy them at 15% and the bond market drops to the point where they are 16% I don't care. I'm satisfied with my $100,000 becoming $400,000 by 1994-95 (and, of course, I'm just using these figures as examples).

Question: I know that each era has its advantages and its pitfalls. How does today's situation compare with what you've seen in the past?

Answer: When I was a boy the world seemed tough, jobs were tough, but your money felt safe. A friend of mine once said, "When I was a kid a ham sandwich was only a quarter. The only trouble was that I didn't have a quarter then."

Back in the later 1930s and early 1940s there was no fear of inflation. But money was hard, very hard to come by. We didn't worry about the banks and government debt. We just worried about finding a job and making a living. Now there's money around, and everybody feels that someone or some institution owes them a living. But the government has become "the enemy," and we wonder where the enemy will strike next. You never hear anybody today talking about "my government." No, it's "the government," and generally a few choice epithets follow the phrase.

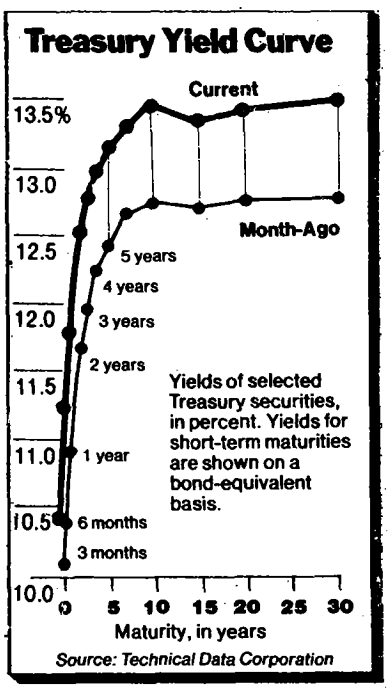
To give you an example which I've been thinking about. Today we have Social Security and pension plans and IRAs. I already distrust the Social Security situation. I think they'll cut me out before I ever collect. And as for the pension plans and IRAs, I've noticed that the taxes tend to go where the money is. It's been estimated that pension plans will hit over $1 trillion in the 1990s. Therefore, I expect the government and the IRS to start scrutinizing the pension plan area for all sorts of new taxes. "Why the pension plan sector?" you protest. And I answer, "Because that's where the money is." Maybe they'll put a ceiling on what you can take out, maybe they'll raise the taxes on individual income from the current 50% to 60% or 70%. But I know how politicians and lawyers think, and I'm telling my subscribers right now that the pension area will be a juicy target. This is a hungry government, and the pension plans are big fat limbs.

Another item worth discussing is Russia. Never before (since the Colonial days) has a foreign power been a real threat to the US. But Russia is a military threat now, and as a result it will cost a massive amount to insure the safety and freedom of this country. It remains to be seen how much today's Americans will be willing to sacrifice to stay free. America, in the past, has been willing to sacrifice everything for freedom. During the next ten years it is my opinion that our will for freedom will be sorely tested–tested as never before in modern history.

YIELD CURVE: Everyone interested in money markets watches the yield curve. The curve is simply a line connecting the yields on various categories of maturities. The most important yield curve is the one defining government securities. The accompanying chart shows the story.

What we see here is most interesting. Going out three months (these are T-bills) we have interest rates around 10%. Going out 2 years (these are T-notes) interest rates climb to 11.6%. Then going out 7-8 years the notes go over 13% yield. And at ten years we start pushing 13.4% in interest.

What this shows us is that investors are playing it short and safe. In other words, they are giving up better than 3% in interest



(which they could get on 8-year notes) to stay short in T-bills. That doesn't indicate monetary pressure, it implies fear of what lies ahead (inflation, bigger deficits, etc.).

The yield curve is now termed "positive" because the far-out yields are higher than the near-term yields. This is normal, since the further out one goes, the greater the risk, and risk is measured in terms of higher yields.

But there are times of crisis when the pressure is on for money. At such rare times, lenders do not want to lend for very long. In other words, they are willing to lend for a few months to a year, and only at very high rates. When that happens, the short-term rates explode (since everyone wants money, and the price of money then climbs). T-bill rates in such situations can climb above long-term bond rates. This gives rise to the "negative yield curve." The negative yield curve is, therefore, indicative of a severe squeeze in the money markets.

Back in 1982 during the monetary crisis the 20-year T-bonds hit 15.75 at their peak, and the T-bills went even higher as the yield curve turned negative. One of the things that currently bothers money market men is this: here we are with the long bonds at 13.5%, and the yield curve is still very positive. What happens if we go into another money crisis, and the yield curve turns negative again? Under such conditions, who knows how high the long bonds could go or how much above the long yields the T-bill yields could go? In other words, it's frightening that with the yield curve currently so positive that the long-term bonds are already above 13% yields.

Bond traders know that when an economic expansion is underway (as now) it almost always ends in a negative yield curve (as the Fed steps in to halt the inflationary forces). Thus, Wall Street waits for "the inevitable," the onslaught of the negative yield curve.

Here is another item that few investors are aware of. The recent auction saw the 30-year Treasury bonds go for a coupon of 13.25%. This was the highest 30-year T-bond coupon in history. Never before has the Treasury had to pay so much for 30-year money. And as an indication of current fear of the long-term, these bonds are now selling under par to yield 13.44%.

Question: Russell, what can the bond market be thinking of? Why are the long bonds so high when money is not that tight?

Answer: In my opinion, the bond market is worried sick about the long-term implications of the compounding government deficits and the fact that nothing really fundamental is being done about these deficits. At the rate we are going (give or take $100 billion a year, and I'm serious about that) the debts and deficits will be totally unmanageable by the early 1990s, and I don't care whether we're in a boom or a depression. Thus, the bond market is saying, "I don't want to go out past five years in maturities; it's too scary. But if I have to (even though inflation is minimal now) I want better than 13% on my money." Put it this way: if Congress came out with a valid plan for eliminating the US budget deficits, you'd see the biggest collapse in interest rates in history. Yeah, Russell, and if elephants could fly . . . .

Question: Russell, you've been saying for years that the federal deficits must be attacked head-on. But Congress is still playing footsie with the deficits. What will make them move?

Answer: My old adage still holds, "The politicians will only move when their backs are to the wall. And then, they will only move enough to bring the (people's) screaming down to a low-level groan."

NOTES & QUOTES: Congress, still abysmally ignorant of how the markets work, seems to think that by burning the investors they can kill the market. There is a move afoot to make all precious metal and collectible profits merely short-term gains subject to regular income taxes with no chance of capital gains no matter how long you hold these items. Thus, a wealthy investor, seeking to hedge against inflation by buying gold, would find any long term gains treated as ordinary income with his profits subject to taxes of 50% federal plus state taxes. This would just about kill the incentive to buy gold or silver. There, that should finish off these guys who are speculating on inflation, eh!

* *

TWO's . . . The two-seater sports car has returned. The biggest success story of 1984 is Pontiac's (underpowered) Fiero, and 62 thousand of these little cars have been sold since their introduction last fall. Toyota, Chrysler, Buick, and Cadillac will also be introducing two-seater sports cars. I have three two seaters, a 1974 Porsche 914 (really a styled VW) and two Jaguar E-Types, a 1969 coupe and a 1965 roadster (convertible). To my mind, the Jag E-Types (1961-1965) were the most beautiful cars ever to hit the road. They look like torpedos, and they go like rockets. The E's were built to hit 140-150 MPH, and they could hold 120 MPH for hours. When the E's came out they sold for under $6,000. Now good copies of the roadsters sell for above $20,000.

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How much debt is there in the US? According to the Fed, there is now $5.406 trillion in debt, federal, state, muni, household, corporate, etc. Figuring that the debt may average around 10% to service (my figure is VERY conservative), this means that the total interest bill in the US is around $540 billion a year or almost over $2 billion per day! The US government contributed the biggest percentage boost, its debts rising 14.2% in the first quarter.

* *

Nobody knows the extent of paper and real losses due to the bond market's collapse. But figuring that the debt market dropped around 10% so far this year, we can say that the $5 trillion in US debt suffered a loss of near $500 billion. Here's a squib from last week's WSJ about San Jose, California. Like everyone else, they took a bath in the money markets.

SAN JOSE, Calif.—Municipal officials here said the city incurred a loss of about $60 million in its portfolio after selling and hedging government securities.

Leslie R. White, assistant city manager, said city officials early last week discovered "that there was a severe problem" with the city's funds being tied up in long-term investments. Mr. White said securities thought to have maturities of one to two years had an average maturity of about 17 years.

Mr. White said three city officials who were primarily responsible for making the investments—were put on administrative leave Monday.

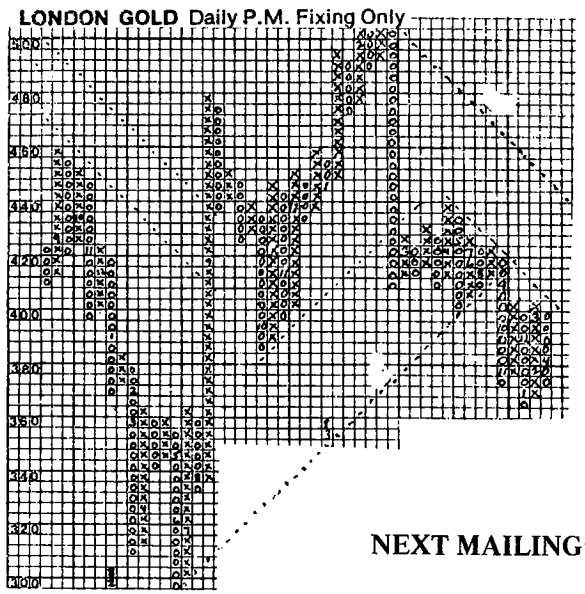
GOLD: Although I always try to be objective and unemotional about the markets, I try doubly hard with gold. If gold goes up—great. If gold goes down—great. I just want my subscribers on the right side of it—either way.

Let's take a long look at the gold action. The metal topped out from a parabolic curve as it exploded to 850 in January 1980. It then collapsed to a late-1982 low of 295. From the 295 low gold pushed up to 504 in February 1983. From there gold dribbled off to its recent low of 368 in January 1984. Since then the life seems to have gone out of gold, as it has drifted up and down between 368 and 404.

The vertical downside count on my point & figure chart (counting down from the 504) is 216. This count will be erased if gold can push to 408 and preferably above the April 1983 high of 400.

Gold has held below its long-term bearish trendline ever since the 850 high of January 1980. More recently (see chart), gold had held below the bearish trendline extending down from the 504 high. Finally, gold has broken below the bullish trendline that extends up from the 300 low as shown on the chart. A trend is taken to remain in force until proved otherwise. On an unemotional reading of the price action, gold must be considered in a long-term bear market.

From the sentiment side, here is the US banking system wobbly, a basket case. And gold still idles about under 500. Five years ago I would not have believed that this could happen to gold. But it has. When the primary trend is down, news (good or bad) seems merely to provide more fodder for the bears.



NEXT MAILING: June 13